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The Proposed Securities Private Enforcement Reform Act: The Introduction of Proportionate Liability into Rule 10b-5 Litigation

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THE PROPOSED "SECURITIES PRIVATE ENFORCEMENT
REFORM ACT": THE INTRODUCTION OF
PROPORTIONATE LIABILITY INTO RULE 10b-5 LITIGATION

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I. INTRODUCTION

When originally enacted, the Securities Act of 1933¹ and the Securities and Exchange Act of 1934² were designed to provide investors protection from fraudulent activities and to promote ethical standards of honest and fair dealing.³ Driven by this philosophy, the courts fashioned an implied private cause of action for violations of Section 10(b) of the 1934 Act and Securities and Exchange Commission Rule 10b-5,⁴ which was to provide a means of

¹Securities Act of 1933, ch. 38, title I, § 1, 48 Stat. 74 (codified as amended 15 U.S.C. §§ 77a-bbbb (1988)) [hereinafter 1933 Act].

²Securities Exchange Act of 1934, ch. 404, title I, § 1, 48 Stat. 881 (codified as amended 15 U.S.C. §§ 78a-ll (1988)) [hereinafter 1934 Act].

³*Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (describing the purposes behind the 1933 and 1934 Acts).

⁴Rule 10b-5, promulgated by the Securities and Exchange Commission in 1942 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

furthering the deterrence rationale of the Securities Acts and, more importantly, to create a means of compensation for those investors who had been defrauded.⁵

Under the current system, defendants found liable for a 10b-5 violation are jointly and severally liable for the full amount of the judgment.⁶ Therefore, a defendant who did not know of the fraud but was reckless in her failure to discover its existence may be held liable for the full amount of the judgment, regardless of how minimally her conduct contributed to the alleged wrong.⁷ The classic rationale for joint and several liability is that as against innocent investors and marginally culpable defendants, it is more important to make the investors whole than limit a "guilty" defendant's exposure to proportionate liability.

However, in 1994, this rationale may involve such tremendous risks to the economic environment that the total cost outweighs forcing defendants, who often times are not the actual perpetrators of the fraud, to pay the entire damages of the investors. For example, joint and several liability fuels intense pressure to bring and settle unmeritorious suits.⁸ Also, meritorious suits against marginally culpable defendants may settle at too high a price due to the ominous risk of exposure to full liability.⁹ Furthermore, so called "risky" clients are no longer given easy access to capital markets. The risk of liability concomitant with such clients outweighs the compensation gained from providing them the legal or accounting services necessary for capital formation.¹⁰

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or,

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1994) [hereinafter cited as Rule 10b-5].

⁵ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150 (1972); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 (1971); see also Tomar Frankel, *Implied Rights of Action Under the Federal Securities Laws*, 67 VA. L. REV. 553, 555 (1981).

⁶ See generally, LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1049 (3d ed. 1995).

⁷ *Id.*

⁸ See generally Janet C. Alexander, *Do the Merits Matter? A Study of Settlement in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

⁹ *Id.*

¹⁰ See Daniel R. Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 BROOK. L. REV. 1051, 1054-55 (1987).

In response to this dilemma, new legislation entitled the Securities Private Enforcement Reform Act¹¹ has been introduced in Congress. At the heart of this legislation is tailoring the liability of defendants to the degree of their culpability through the introduction of proportionate liability into 10b-5 litigation. For this legislation to be viable it seems clear that the risks mentioned above must provide adequate justification for allowing "guilty" defendants to pay only a proportionate share of the damages based on their degree of fault at the expense of investors possibly being made less than whole.

The purpose of this note is to evaluate the ramifications of this particular proposed amendment to the 1934 Act. Part II will summarize the current status of the proposed bill and its provisions. Part III will briefly survey the history and requirements of the private cause of action under Rule 10b-5, particularly the scienter requirement because of its impact on the understanding of the proposed reform. Finally, Part IV will address the justifications for the proposed reform, and the effects the reform will have on 10b-5 litigation.

II. STATUS AND SUMMARY OF THE PROPOSED LEGISLATION

The proposed Securities Private Enforcement Reform Act was introduced during the 102nd Congress and would apply to implied private actions brought under 10(b)¹² of the 1934 Act and Rule 10b-5. On August 11, 1992, the Bill was introduced in the House¹³ by Democratic Representative William J. Tauzin and in the Senate¹⁴ by Republican Senator Pete V. Domenici on August 12, 1992. During the 102nd Congress both bills were submitted to committee and were not reported on before the end of the term. On January 5, 1993, during the 103rd session of Congress, the House Bill¹⁵ was re-introduced by Representative Tauzin and submitted to the House Energy and Commerce Committee, where it remains pending.¹⁶ The last action taken on the House Bill was March 24, 1994. The Senate Bill has yet to be re-introduced.

¹¹H.R. 417, 103d Cong., 1st Sess. (1993).

¹²Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

¹⁵U.S.C. § 78j(b) (1988) [hereinafter cited as section 10(b)].

¹³H.R. 5828, 102d Cong., 2d Sess. (1992).

¹⁴S. 3181, 102d Cong., 2d Sess. (1992).

¹⁵H.R. 417, *supra* note 11.

¹⁶139 CONG. REC. H 111 (daily ed. Jan. 6, 1993).

The proposed legislation expressly states that "[e]xcessive securities litigation is a serious burden on the national economy",¹⁷ and "[t]he meritless lawsuits filed under Federal Securities laws are making it harder for American companies to raise capital and attract experienced members to serve on their boards."¹⁸ In order to reform the securities laws and alleviate the problem of "strike suits" (suits brought for their settlement value alone) the House Bill proposes a number of different measures. The House Bill would create a two-tiered liability system for Rule 10b-5 securities cases, recognizing that less culpable defendants should be treated differently than those who intentionally commit securities violations. The House Bill would impose joint and several liability for 10b-5 violations only on defendants who engage in "knowing securities fraud",¹⁹ which is defined as the "making of a false statement with actual knowledge of its falsity or omitting to make a statement with the actual knowledge that as a result of the omission, material representations made are false."²⁰ Reckless conduct would not be sufficient to establish a "knowing" violation.²¹ However, reckless behavior is not exonerated from liability; rather, defendants who are reckless will be liable solely for the portion of the damages for which a jury finds them responsible.²² Therefore, "less" culpable defendants would not be required to compensate the plaintiff for damages attributable to the actions of other parties. This provision of the legislation would relate only to the allocation of damages; it expressly would not affect the standards for determining liability for implied private actions under 10b-5.²³

In order to provide a disincentive to plaintiffs bringing securities actions merely for their settlement value, the House Bill incorporates an attorney's fee shifting provision.²⁴ Under this provision, a losing party or his attorney may be required to pay the attorney's fees incurred by the winning party under certain circumstances. The House Bill does not mandate automatic fee shifting, but requires the loser to pay the winner's fees only if two conditions are

¹⁷H.R. 417, *supra* note 11, § 2(1).

¹⁸*Id.* § 2(2).

¹⁹*Id.* § 20B(1).

²⁰*Id.* § 20B(3)(A).

²¹*Id.* § 20B(3)(B).

²²H.R. 417, *supra* note 11, § 3(a)(2)(A)-(B). Under the statutory scheme the trier of fact will determine the percentage of responsibility of not only the named individual and entity defendants, but the plaintiff's degree of responsibility as well. In making this determination the jury is to consider the nature of each person's conduct and the causal relationship between this conduct and the alleged harm. After these percentages have been found, a defendant's contribution to the plaintiff's damages is to be calculated by multiplying his percentage by the total amount of damages suffered by the plaintiffs. No defendant whose liability is determined under this proportionate scheme is to be held jointly liable on any judgment entered against another party.

²³*Id.* § 3(a)(2)(A)(4); *see also infra* text accompanying notes 42-69.

²⁴H.R. 417, *supra* note 11, § 3(a)(4)(B).

satisfied. First, if the losing party establishes that its position was substantially justified, it is not required to pay the winner's fees.²⁵ Second, fees may be awarded only if the losing party was put on notice that he might have to pay attorney's fees, and a judicial determination had already been made that the case was not substantially justified.²⁶ If the court issues such a finding and grants the fee shifting motion, the prevailing party is eligible to recover any fees incurred in the litigation from that point forward.

Furthermore, the legislation expressly would eliminate four abusive practices found to be associated with the filing of 10b-5 actions. First, in class actions, representative plaintiffs would no longer be permitted to obtain a recovery greater than that of the other plaintiffs in the class unless the additional sum is justified as compensation for costs actually incurred.²⁷ Second, an attorney could not represent a class when he is a beneficial owner of the securities that are the subject of the litigation.²⁸ Third, securities brokers and dealers could not receive "steering fees"²⁹ for referring customers to an attorney.³⁰ Fourth, funds disgorged as the result of an SEC enforcement proceeding would have to be paid to victims of fraud and could not be used to compensate private attorneys.³¹

The proposed legislation would also extend the current statute of limitations in securities actions, which requires securities fraud lawsuits to be brought within one year after the date on which the violation was discovered but not later than three years after the date on which the violation occurred.³² The House Bill would require the lawsuit to be brought within one year after the date of discovery of the violation and not later than five years after the date the violation occurred.³³

²⁵*Id.*

²⁶*Id.*

²⁷*Id.* § 3(c)(1). This provision is aimed at the elimination of "professional plaintiffs" from 10b-5 actions. Plaintiffs, who have very little at stake in the lawsuit, act as the representative in class actions merely to recover the extra compensation allotted to the representative of the class. Under the new scheme, the representative's share of the final judgment will be calculated in the same manner as all other members of the class.

²⁸*Id.* § 3(c)(2)(A).

²⁹H.R. 417, *supra* note 11, § 3(c)(2)(B). Steering fees are payments made to third parties who assist plaintiff's attorneys obtain representation of a party in an action.-

³⁰*Id.*

³¹*Id.*

³²*See* *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct. 2773, 2782 (1991). The Court in *Lampf* eliminated the long standing practice of choosing relatively liberal state statutes of limitation for 10b-5 actions and substituted the uniform federal rule. *Id.*

³³H.R. 417, *supra* note 11, § 4.

As a further curb on abusive practices, the House Bill contains a number of additional proposed reforms not found in the Senate Bill, proposed during the 102nd Congress. First, plaintiffs, in order to satisfy their burden of proof of fraud, would be required to prove allegations of fraud by clear and convincing evidence, as opposed to the current preponderance of the evidence standard of proof.³⁴ Also, plaintiffs, in pleading the scienter requirement,³⁵ would be required to allege specific facts in their complaint indicating that the defendant acted with scienter or an intent to defraud.³⁶ Finally, secondary actors, such as accountants, lawyers, or underwriters would not be liable for aiding and abetting another defendant's violation of the securities laws unless the plaintiff could prove that the secondary actor acted "with deliberate intent to deceive, manipulate, or defraud for the defendant's own direct pecuniary benefit".³⁷

III. BRIEF SURVEY OF THE 10b-5 IMPLIED RIGHT OF ACTION

To fully analyze the impact of the introduced House Bill on 10b-5 actions, the judicial requirements and origins of the 10b-5 private right of action must be considered. The dominant private remedies for securities fraud are provided by section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.³⁸ Although well established today, an implied right of action under section 10(b) and Rule 10b-5 was not initially recognized; in fact, a private right of action had to be judicially implied because section 10(b) does not expressly authorize private actions.³⁹ However, relying on tort principles, the court in *Kardon v.*

³⁴*Id.* § 3(d).

³⁵See *infra* text accompanying notes 42-50.

³⁶H.R. 417, *supra* note 11, § 3(e). Federal Rule of Civil Procedure 9(b) requires that "the circumstances constituting fraud . . . be stated with particularity. Malice, intent, knowledge and other conditions of mind of a person may be averred generally." Despite this approach to pleading the state of mind of the defendant, courts have reached different conclusions on the pleading requirement under section 10b-5. Compare *Ross v. A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979) with *Auslender v. Energy Management Corp.*, 832 F.2d 354, 357 (6th Cir. 1987). The legislation will end the dispute by requiring that plaintiffs plead the "scienter" component of 10b-5 actions with specific facts. Many commentators feel that a strict requirement for pleading "scienter" runs afoul to the notice pleading standards of the Federal Rules of Civil Procedure. See Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667, 676 n.30 (1991); Richard L. Marcus, *The Revival of Fact Pleading Under the Federal Rules of Civil Procedure*, 86 COLUM. L. REV. 433, 477 (1986). But see Note, *Using Rule 9(b) to Reduce Nuisance Securities Litigation*, 99 YALE L. J. 1591, 1601 (1990).

³⁷H.R. 417, *supra* note 11, § 3.

³⁸See generally John A. Maher, *Implied Private Rights of Action and the Federal Securities Laws: A Historical Perspective*, 37 WASH. & LEE L. REV. 783 (1980) (surveying the development of private actions under the securities laws).

³⁹*Id.*

*National Gypsum Co.*⁴⁰ implied a private action for violations of Rule 10b-5. Twenty five years later, the Supreme Court confirmed the existence of a private right of action under Section 10(b) in *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*⁴¹

Having created this private right of action, without the guidance of a legislative framework, the courts necessarily obligated themselves to the development of a federal common law. Although acting amidst a certain degree of doctrinal uncertainty due to the lack of legislative action, the courts have mandated several elements of a 10b-5 private cause of action; the most important of these elements for purposes of this discussion is the *scienter* requirement.⁴² In *Ernst & Ernst v. Hochfelder*,⁴³ the Supreme Court held that a

4069 F. Supp. 512 (E.D. Pa. 1946). In justifying the creation of an implied right of action, the court reasoned that securities legislation was created primarily to protect the interest of the individual investors and stated,

the violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if; (a) the interest of the enactment is exclusively or in part to protect an interest of the other as an individual; and (b) the interest invaded is one which the enactment is intended to protect.

Id. at 513 (quoting the Restatement of Torts § 286 (1934)).

41 404 U.S. 6, 13 n.9 (1971).

42 In addition to *scienter*, under Rule 10b-5 a private plaintiff must plead and prove the following elements:

(1) Purchaser/Seller. The plaintiff must be a purchaser or seller of a security. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975).

(2) Materiality. The fact omitted or misrepresented must have been material. A fact is material "if there is a substantial likelihood that a reasonable...[investor] would consider it important." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474 (1977); *Madison Consultants v. FDIC*, 710 F.2d 57, 62 (2d Cir. 1983); *Simpson v. Southeastern Inv. Trust*, 697 F.2d 1257, 1259 (5th Cir. 1983); *Austin v. Loftsgaarden*, 675 F.2d 168, 176 (8th Cir. 1982).

(3) "In Connection With." The fraud must have occurred "in connection with" the purchase or sale of a security. *See supra* note 12 (text of Section 10(b)); *supra* note 4 (text of Rule 10b-5); *see also Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 10 (1971) (addressing scope of "in connection with" requirement).

(4) Reliance. Generally, a plaintiff must have relied on the fact that was omitted or misrepresented. Where the fact was omitted, plaintiffs reliance is presumed. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972); *see also Huddleston v. Herman & Maclean*, 640 F.2d 534, 548 (5th Cir. 1981), *rev'd in part on other grounds*, 459 U.S. 375 (1983); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1048 (7th Cir. 1976), *cert. denied*, 434 U.S. 875 (1977).

(5) Causation. The injury to the plaintiff must result from the omission or misrepresentation. *See Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 61 (2d Cir. 1985); *Huddleston*, 640 F.2d at 549; *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978).

(6) Jurisdictional Means. The defendant must have used interstate commerce, the mails, or a facility of a national securities exchange in committing the violation. *See Affiliated Ute Citizens*, 406 U.S. at 148 (affirming district court's holding that the defendants in the case had made use of the required jurisdictional means).

private cause of action for damages will not lie under Rule 10b-5 in the absence of any allegation of scienter. The Court defined scienter as "[a] mental state embracing intent to deceive, manipulate, or defraud."⁴⁴ However, the Court failed to precisely define the boundaries of the *scienter* requirement and expressly left open the question whether "[i]n some circumstances, reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5."⁴⁵ In two subsequent decisions, the Court merely repeated its application and definition of the *scienter* requirement and did not expand on its applicability to reckless conduct.⁴⁶

In light of the Supreme Court's failure to address the recklessness standard the onus was left on the lower federal judiciary to do so. The lower courts, notwithstanding *Hochfelder's* emphasis on intentional conduct in the formulation of the *scienter* requirement, concluded that recklessness satisfied the *scienter* requirement for 10b-5 liability.⁴⁷ Due to lack of guidance, the body of law created by the lower federal courts, in many instances, seems to lack any form of precision or predictability, and, as a result, recklessness determinations have become nearly *ad hoc* and arbitrary.⁴⁸ One judge may deem an accused party to have acted recklessly, while a different judge in another case may

⁴³425 U.S. 185 (1976).

⁴⁴*Id.* at 194 n.3.

⁴⁵*Id.* The Supreme Court again failed to decide the issue in *Herman & Maclean v. Huddleston*, 459 U.S. 375, 378 n.42 (1983). Despite continued ambiguity regarding the content of the Court's scienter requirement, the *Hochfelder* opinion clearly excluded a negligence standard from the 10b-5 culpability spectrum. Because the Court side-stepped the question of whether recklessness was a culpable mental state under 10b-5 and other questions, *Hochfelder* has been described as "puzzling" and "leaving as many questions as it answers." LOSS, *supra* note 6. However, given the Court's heavy emphasis on intentional conduct in its definition of scienter, a recklessness standard for liability seems beyond the intentions of the Court; many scholars agree. See generally, Johnson, *supra* note 36; James D. Cox, *Ernst & Ernst v. Hochfelder: A Critique and Evaluation of its Impact upon the Scheme of Federal Securities Laws*, 28 HASTINGS L.J. 569, 628 (1977).

⁴⁶See *Dirks v. SEC*, 463 U.S. 646, 663 n.23 (1983) (quoting *Hochfelder's* definition of scienter); *Aaron v. SEC*, 446 U.S. 680, 686 n.5 (1980) (reiterating *Hochfelder's* narrow definition of scienter and holding that scienter was necessary to establish entitlement to injunctive relief in SEC enforcement actions brought under section 10(b)).

⁴⁷See *Van Dyke v. Coburn Enter.*, 873 F.2d 1094, 1100 (8th Cir. 1989); *Woods v. Barnett Bank*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Hackbart v. Holmes*, 675 F.2d 1114, 1117 (10th Cir. 1982); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961 (5th Cir. 1980), *cert. denied*, 454 U.S. 965 (1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979); *Nelson v. Serqold*, 576 F.2d 1332, 1337 (9th Cir. 1977) (*per curiam*), *cert. denied*, 439 U.S. 970 (1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir. 1977), *cert. denied*, 439 U.S. 1039 (1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1976), *cert. denied*, 434 U.S. 875 (1977).

⁴⁸See *infra* text accompanying notes 51-59.

exonerate a defendant charged with nearly identical misconduct.⁴⁹ As will be shown it is this imprecision that is a primary culprit of many of the abusive practices and results in 10b-5 litigation. The proposed legislation does not propose to eliminate the recklessness standard,⁵⁰ however, a further investigation into this spectrum of liability is essential to understanding the problems facing Rule 10b-5 defendants.

The lower courts' attempts at determining when conduct satisfies the reckless *scienter* standard for 10b-5 liability can best be described as creating a spectrum of culpability.⁵¹ At one end of the spectrum the courts require a showing of "severe recklessness." In *G.A. Thompson & Co. v. Partridge*,⁵² the court found a conscious purpose to avoid learning the truthfulness of the circumstances as central to their definition of severe recklessness.⁵³ In light of the *Hochfelder* Court's emphasis on intentional conduct, the court reasoned that only when a defendant acts consciously should 10b-5 liability be extended.⁵⁴ However, as is true for other tests, the severe recklessness rubric may serve as no more than a convenient label than as a true analytical device.⁵⁵

⁴⁹For example, in *McDonald v. Alan Fush Brokerage Co.*, 863 F.2d 809, 810 (11th Cir. 1989), the court held that an investment broker was entitled to a directed verdict on a 10b-5 claim when he recklessly provided poor advice. On the other hand, the court in *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434, 1436 (9th Cir. 1984), held that an investor was entitled to have a jury hear his claim when an investor had provided investment advice which he should have known was poor. Compare *Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335, 1340 (9th Cir. 1980) (which held that an accounting firm was entitled to summary judgment on a claim that the firm recklessly failed to follow auditing standards) with *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1306-07 (9th Cir. 1982) (where the court denied summary judgment given facts almost identical to those in *Pegasus*).

⁵⁰See *supra* text accompanying notes 21-23.

⁵¹See Johnson, *supra* note 36. In an attempt to provide predictability to the recklessness determination, the article suggests that when an actor did not stand in a position to gain a direct profit from the fraud that a fact-finder should presume that the defendant did not act recklessly. See *Riedel v. Acutote of Colo.*, 773 F. Supp. 1055, 1065-66 (S.D. Ohio) (considering whether the defendant knew of the misleading or omitted material and stood to receive pecuniary gain in evaluating scienter based on recklessness), *appeal dismissed*, 947 F.2d 945 (6th Cir. 1991); see also *Woods v. Barnett Bank*, 765 F.2d 1004, 1010 (11th Cir. 1985); *Warren v. Reserve Fund, Inc.*, 728 F.2d 741, 746 (5th Cir. 1984); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961 (5th Cir. 1980), *cert. denied*, 454 U.S. 965 (1981).

⁵²636 F.2d 945 (5th Cir. 1981).

⁵³*Id.* at 961.

⁵⁴*Id.* at 960-61.

⁵⁵See Marc I. Steinberg & Samuel H. Gruenbaum, *Variations of "Recklessness" after Hochfelder & Aaron*, 8 SEC. REG. L.J. 179, 200-03 (1980) (arguing that the lack of uniformity in the application of the "severe recklessness" test indicates that the courts have defined their own notions of severe recklessness based upon personal notions of equity).

At the opposite end of the spectrum is a level of culpability that has been termed the "barely reckless" standard. In *Stern v. American Bankshares Corp.*,⁵⁶ the court held that the corporate officers and directors were reckless if they knew or should have known of the facts and circumstances concerning the fraud.⁵⁷ The "barely reckless" standard seems inconsistent with the *Hochfelder's* emphasis on intentional conduct and is dangerously close to a simple negligence standard which was held to be insufficient in the formulation of the *scienter* requirement.⁵⁸ It epitomizes the significant variation in the standards for recklessness under section 10(b) and Rule 10b-5.

The most common definition of recklessness for purposes of 10b-5 claims is the one presented by the court in *Sundstrand Corp. v. Sun Chemical Corp.*⁵⁹ In *Sundstrand*, the court, emphasizing that reckless conduct had objective as well as subjective components, defined recklessness as an "[e]xtreme departure from standards of ordinary care . . . which presents a danger . . . either known to the defendant or . . . so obvious that the actor must have been aware of it."⁶⁰ Again, some of the language used by the *Sundstrand* court resembles a simple test for negligence. For this reason, although popular, *Sundstrand* has been criticized specifically because the line between an extreme departure from the standards of ordinary care (recklessness under *Sundstrand*) and a simple departure from these standards (negligence) cannot be easily drawn.⁶¹

The recklessness standard for 10b-5 culpability arguably does further the intentions of the 1933 Act and the 1934 Act. Injured investors, under this standard, do not bear the heightened burden of proving that defendants acted with intent. However, the fact-intensive and many times ad hoc nature of determining when a defendant has acted recklessly in a 10b-5 action means that minimally culpable defendants may face crushing liability and is a major incentive to the very strike suits which the proposed legislation seeks to abate. The result of this ad hoc methodology is that actual and potential parties to a Rule 10b-5 action cannot predict with any degree of certainty how a trier of fact

⁵⁶429 F. Supp. 818 (E.D. Wis. 1977).

⁵⁷*Id.* at 826.

⁵⁸See *supra* note 45.

⁵⁹553 F.2d 1033 (7th Cir. 1976), *cert. denied*, 434 U.S. 875 (1977).

⁶⁰*Id.* at 1045 (quoting *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976), *vacated on other grounds sub nom. Cronin v. Midwestern Okla. Dev. Auth.*, 619 F.2d 856 (10th Cir. 1980); see also *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 n.7 (9th Cir. 1990) (en banc) (the rationale of the court was that it will bring greater uniformity to the law of the various circuits), *cert. denied*, 111 S. Ct. 1621 (1991); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193-94 (3rd Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).

⁶¹See *Johnson, supra* note 36; Paul S. Milich, *Securities Fraud under Section 10(b) and Rule 10(b)-5: Scienter, Recklessness and the Good Faith Defense*, 11 J. CORP. L. 179, 193-95 (1986).

will characterize challenged conduct and, thus, whether it may serve as the basis for liability.⁶²

Utilizing the recklessness standard for culpability under 10b-5 actions, plaintiffs can cast a much wider net to draw upon deep pocket professionals, such as accounting firms, lawyers and investment bankers, who have given advice on the transactions which led to the allegedly fraudulent occurrence.⁶³ This wide net is essential for plaintiffs because, often when securities fraud is discovered, the primary offender is insolvent.⁶⁴

Recognizing this problem and seeking to enhance relief for securities fraud, the lower federal courts created a cause of action for aiding and abetting securities fraud violations.⁶⁵ Recently, however, the Supreme Court in *Central*

⁶² See Johnson, *supra* note 36.

⁶³ Defendants formerly sued solely as alleged aiders and abettors made ideal "deep pockets" because, if found liable they were jointly and severally liable with the primary violator. The classic illustration of the "wide-net" of liability is *Landy v. FDIC*, 486 F.2d 139, 153 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1970), in which the plaintiffs sued not only the president of the bank, who had stolen money to speculate on the stock market, but also the New York Stock Exchange, the Federal Reserve Bank of New York, the Federal Deposit Insurance Corporation, another bank, the bank's outside accountants, 12 brokerage firms that executed stock transactions for the president, and 16 individuals associated with those firms. See generally John T. Vangel, *A Complicity-Docctrine Approach to Section 10(b) Aiding and Abetting Civil Damages Actions*, 89 COLUM. L. REV. 180 (1989) (Where the mental state line is drawn on the intent-recklessness spectrum directly determines the probability of remote-party liability. Due to the relative ease of proving a reckless state of mind [simply point out a defendant's failure to meet regulatory standards or professional guidelines], a recklessness standard dramatically increases the probability of remote-party liability which seems to decrease a defendant's willingness to go to trial); David Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, Contribution*, 120 U. PA. L. REV. 597, 599 (1972) (noting the ingenuity of the plaintiffs joining "secondary defendants"); Harris J. Amowitz, *The Accounting Profession & The Law: The Misunderstood Victim*, J. ACCT., May 1987, at 356, 359.

⁶⁴ For example, in *Edwards & Nahly v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 481 (2d Cir. 1983), *cert. denied*, 444 U.S. 1045 (1984), the primary 10b-5 violator, the broker who sold the securities, was insolvent due to fraudulent short sales concealed from a bank. Due to this insolvency the plaintiff could only recover if it could locate a solvent party who took part in the transactions; a clearance corporation was joined. See also Don J. McDermott, Jr., Note, *Liability for Aiding and Abetting Violations of Rule 10(b): The Recklessness Standard in Civil Damage Actions*, 62 TEX. L. REV. 1087, 1104 (1991); Ruder, *supra* note 63.

⁶⁵ One of the earliest reported securities cases dealing with aider and abettor liability analogized the cause of action to the field of criminal aiding and abetting, especially to fraud. *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 37 (N.D. Cal. 1939), *rev'd in part on other grounds*, 142 F.2d 744 (9th Cir. 1944). The seminal case in the development of the 10b-5 aiding and abetting doctrine is *Brennan v. Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). *Brennan*, is considered to be a landmark case for two reasons. First, the *Brennan* court held that 10b-5 liability can be imposed on a defendant who was not a primary participant in the fraudulent activity. *Id.* at 680-81. Second, the court expressly based aiding and abetting liability on section 876(b) of the Restatement Second of Torts, which

Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,⁶⁶ held that a private plaintiff may not maintain a suit for aiding and abetting under section 10(b). The Court in *Central Bank* relied upon the text of section 10(b) to conclude that the implied private right of action does not extend to aiders and abettors.⁶⁷ In so holding the Court avoided deciding the difficult issue of whether proof of reckless conduct was sufficient to establish aiding and abetting liability. As with the *scienter* requirement necessary in the primary violation context of 10b-5 actions,⁶⁸ the appropriate standard to effectuate the "knowledge" requirement of aiding and abetting liability was equally expansive and dependent upon the facts of each case and, as a result, equally unpredictable.⁶⁹

An implied private cause of action under Rule 10b-5 has its origins in common law tort liability.⁷⁰ As a result, all defendants found liable, whether as a primary violator with the *scienter* requirement as defined in the *Hochfelder* case or a remote participant who has merely been reckless, will be held jointly and severally liable for the complete judgment obtained by the plaintiff.⁷¹ The sheer magnitude of joint and several liability weighs heavy on the minds of innocent, as well as "guilty", defendants as they make the choice between settlement and trial.⁷² Also, joint and several liability encourages plaintiffs to more readily name secondary actors as defendants and to bring strike suits that,

states that one will be liable for the torts of another if he has knowledge of the act and gives substantial assistance to the tortfeasor. *Id.* at 680; *see also* *Bloor v. Carro*, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 62 (2d Cir. 1985); *Metge v. Baehler*, 762 F.2d 621, 624 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986); *Rolf v. Blyth*, Eastman, Dillon & Co., 570 F.2d 38, 45 (2d Cir. 1977), *cert. denied*, 439 U.S. 1039 (1978); *Landy v. FDIC*, 486 F.2d 139, 162 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

⁶⁶114 S. Ct. 1439 (1994).

⁶⁷*Id.* at 1446.

⁶⁸*See supra* text accompanying notes 42-50.

⁶⁹The knowledge or recklessness element of aider and abettor liability overlaps and many times is equated with the *scienter* requirement of 10b-5 liability. *See, e.g.,* *W.O. Akin v. Q-I Investments, Inc.*, 959 F.2d 521, 526 (5th Cir. 1992); *Stokes v. Lokken*, 644 F.2d 779, 784 (8th Cir. 1981).

⁷⁰*Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

⁷¹Under general principles of tort law, when two or more defendants' joint acts combine to form a single, indivisible injury, they are jointly and severally liable. *See* W. PROSSER, *LAW OF TORTS* § 46 (4th ed. 1971); *see, e.g.,* *W.O. Akin*, 959 F.2d at 530; *Molecular Technology Corp. v. Al Valentine*, 925 F.2d 910, 917 (6th Cir. 1991); *Hoxworth v. Blinder, Robinson & Co., Inc.*, 903 F.2d 186, 202 (3rd Cir. 1990); *In re Warner Communications Sec. Litig.*, 798 F.2d 35, 37 (2nd Cir. 1986); *Arioli v. Prudential-Bache Sec., Inc.*, 792 F. Supp. 1050, 1061 (E.D. Mich. 1992); *Nelson v. Bennett*, 662 F. Supp. 1324, 1328 (E.D. Cal. 1987); *First Fed. Sav. & Loan v. Oppenheim, Appel, Dixon & Co.*, 631 F. Supp. 1029, 1032 (S.D.N.Y. 1986); *Harrison v. Sheats*, 608 F. Supp. 502, 506 (E.D. Cal. 1985).

⁷²*See generally* Alexander, *supra* note 8; Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 18 (1991).

if actually tried, would have little success at trial.⁷³ By fairly apportioning damages among defendants based upon the character of their culpability, the proposed legislation seeks to address these problems in 10b-5 litigation.

IV. CRITICAL EVALUATION OF THE PROPOSED REFORM

As stated in Part I, the justification for the imposition of proportionate liability into 10b-5 litigation must be that the risks associated with joint and several liability outweigh imposing full liability upon defendants who are only marginally culpable in the perpetration of the fraud in order to compensate investors for their total loss. The remainder of this discussion focuses on the risks associated with joint and several liability, and the answers provided by imposing liability proportionately with the degree of fault.

A. Risks of Unmeritorious Settlement and Settlement of Unmeritorious Suits

When the courts began creating and shaping the private implied right of action under Rule 10b-5, their intentions were to further the goals of the 1934 Act, which are aimed at the protection of investors. Specifically, the implied right was to create for investors a means of compensation if they had been defrauded or wronged. However, Rule 10b-5 litigation has turned into nearly a "faultless" system. Due to the circumstances surrounding Rule 10b-5 litigation, such as the unpredictable nature of liability under Rule 10b-5, the risk of being held jointly and severally liable for huge amounts of damages in class actions by shareholders, and the high costs in defending such securities actions, defendants, guilty or not, have no choice but to favor settlement over trial.⁷⁴ The *Central Bank* Court recognized this dilemma and responded by eliminating liability for aiding and abetting. In that case the Court stated:

Because of the uncertainty of the governing rules, entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expenses and risk of going to trial.⁷⁵

Consequently, comparatively less culpable defendants settle for a disproportionate share of the damages in order to avoid trial.⁷⁶ In other words, innocent or marginally culpable defendants are weighing the options and foregoing the opportunity to present their meritorious defenses at trial.

⁷³See generally Lucian A. Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437 (1988); David Rosenberg & Steven A. Shavell, *A Model in Which Suits are Brought for their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985).

⁷⁴See Alexander, *supra* note 8.

⁷⁵114 S. Ct. at 1454.

⁷⁶*Id.*

Generally, settlement is the preferred method of dispute resolution by the courts, not only because it alleviates a heavy case load burden from court dockets, but more importantly because it allows parties to reach a fair agreement concerning their dispute.⁷⁷ In balanced situations parties make decisions about settlement based on rational estimates of the expected economic value of the case after litigation, including the costs of that litigation.⁷⁸ This is commonly referred to as the economic model for settlement negotiation.⁷⁹ The weakness of this model in 10b-5 litigation is that it makes the assumption that the parties are primarily considering the merits of the lawsuit in determining whether to accept or reject a settlement.⁸⁰ Settlement is only a valuable tool in the administration of justice when the merits of the case are considered, for the intended goal is to reflect the discounted value of an actual trial outcome even though there is no adjudication of the facts in the case.⁸¹

In 10b-5 actions the strength of the cause of action on the merits has become largely irrelevant to the settlement process.⁸² First, alleged 10b-5 violators are placed into a position of choosing between settlement and trial because it is extremely unlikely that they will be able to dispose of the case by motion. The materiality and *scienter* requirements previously discussed are highly fact specific, and many courts hold that it is inappropriate to settle such elements by summary judgment.⁸³ Second, the extremely high costs and stakes of securities litigation puts an inordinate amount of pressure on the defendant's decision to settle. For example, it is relatively inexpensive for a plaintiff's firm to file a boilerplate complaint with requests for discovery in comparison with

⁷⁷ See generally William M. Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61 (1971).

⁷⁸ See *Evans v. Jeff D.*, 475 U.S. 717, 734 (1986) ("Most defendants are unlikely to settle unless the cost of the predicated judgment, discounted by its probability, plus the transactional costs of further litigation are greater than the cost of the settlement package.").

⁷⁹ See Alexander, *supra* note 8.

⁸⁰ *Id.*

⁸¹ See Landes, *supra* note 77.

⁸² See Alexander, *supra* note 8. The hypothesis of the article was to prove that the expected value after trial is not the primary determinant of settlement in 10b-5 cases. By selecting a group of cases presumably similar in all respects except for the merits and noticing that the outcomes in each of these cases were similar, the author concludes that there is a negation of the conventional theory that outcomes are a function of expected value and of the merits. One of the most striking uniformities in the examined cases was the finding that every case settled for exactly twenty-five percent of the claimed damages, an amount the author claims is the minimum that would justify the filing of the lawsuit for plaintiff's attorneys.

⁸³ See, e.g., *Celotex Corp. v. Catrett*, 477 U.S. 317, 325 (1986); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247 (1986); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986).

the cost a defendant incurs in having to fulfill such discovery requests.⁸⁴ Finally, the enormous burden of being exposed to joint and several liability for the full amount of a judgment and the risk created by the unpredictable nature of 10b-5 litigation combine to form the greatest deterrent effect to trial for a defendant. As a result of these circumstances, the merits of the case are often a negligible factor in the settlement calculus, because defendants, innocent or marginally culpable, are not willing to take the risk of crushing liability when it is far cheaper to settle.⁸⁵ When adjudication is too great a risk, the merits of the case and the innocence of the defendant recede in significance, and instead settlement negotiations are based primarily on non-merit related factors such as the financial condition of the defendant, the amount of professional liability insurance the defendant carries, and the lawyer's bargaining tactics.⁸⁶

Expressly stated, the main goal of the proposed legislation is to reform the present system of 10b-5 litigation by ensuring that fewer frivolous (meritless) securities fraud suits are filed in federal courts for the primary purpose of coercing nuisance settlements from innocent defendants.⁸⁷ The Bill accomplishes this goal by imposing joint and several liability upon only those defendants who engage in "knowing" securities fraud⁸⁸ and limiting the exposure of those defendants who act with recklessness to proportional liability, or in other words, liability only for their share of the damages award as determined by a jury. By removing the risk that a defendant will be held jointly and severally liable even if found only to have acted recklessly, defendants included merely because of their marginal involvement and deep pockets will now have an incentive to take a case to trial; if they feel the case has no merit or that the merits are weak, they will be more willing to risk an adverse judgment based on recklessness knowing their exposure will be in accordance with the degree of their culpability. Conversely, if they settle, the settlement amount agreed upon will more closely reflect the lesser degree of the defendant's culpability. Therefore, a link is established between the merits and the settlement process by increasing the willingness of defendants to take cases to trial. Under these new circumstances, the economic model for settlements becomes effective because, with a realistic expectation of adjudication on the merits, expected trial outcomes must be considered.⁸⁹

⁸⁴*In re Warner Communications Sec. Litig.*, 618 F. Supp. 735, 739 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986).

⁸⁵See John C. Coffe, Jr., *Is Innocence Irrelevant? Under RICO, Trial Has become Secondary*, LEGAL TIMES, Mar. 13, 1989, at 20 (If defendants can not risk trial, the meritorious factual defenses become irrelevant.).

⁸⁶See Alexander, *supra* note 8.

⁸⁷H.R. 417, *supra* note 11, § 2(4).

⁸⁸See *supra* text accompanying note 20.

⁸⁹See Landes, *supra* note 77.

The consequence of allowing "deep pocket" defendants to pay only their proportionate share of damages may be enormous in the eyes of innocent investors, for without these defendants' money investors may not fully recover their loss. Frequently the most culpable potential defendants are budding enterprises whose earnings were less than expected, and they have not amassed assets sufficient to satisfy a potentially adverse verdict.⁹⁰ In light of this fact, secondary participants with "deep pockets" become the focus of the lawsuit. The balance to be struck by Congress is the innocent investors versus the marginally culpable defendant. Behind the argument of the investors may be justice but behind the argument for the marginally culpable deep pockets is macroeconomics.

B. Risk of Shrinking Capital Markets for "Risky" Start-up Ventures

The concerns regarding the onus of joint and several liability become more acute for market participants such as accounting and law firms. Assuming, *arguendo*, that these entities are generally less culpable due to their limited participation in the allegedly fraudulent transaction, the chance that these less culpable actors' potential liability far exceeds their degree of culpability, and more importantly their pre-determined fees, has a significant impact on the costs and availability of the services that are provided.

Of course, if defendants are found to be knowingly or recklessly liable then there is "guilt" under Rule 10b-5. However, when actors are not found to be purposely fraudulent, there are serious economic downsides to penalizing marginal participation in the allegedly fraudulent activity with full Rule 10b-5 liability. This is of special concern because knowing participants usually are the perpetrators of the fraudulent scheme, and the reckless participants are sued solely for failing to stop or discover the fraud.

Comparative negligence statutes have flourished in tort law, and as has been indicated, a union of tort concepts with Rule 10b-5 would not be inconsistent.⁹¹ The philosophy of these statutes is that negligent parties are only held responsible for their own conduct. The proposed legislation adopts the spirit of the comparative negligence doctrine by proportionately allocating damages among proportionately culpable defendants. As stated, in establishing culpability under Rule 10b-5, the line between recklessness and negligence is often times blurred. In many instances this benefits investors by allowing recovery. However, this same fluidity in culpable mental states that benefits investors provides extra support for the proposed legislation's adoption of comparative negligence philosophy. In this manner the Bill protects marginally culpable accounting and law firms from full liability when their only "mistake" was a failure to stop the fraud.

⁹⁰See W. John Moore, *Litigators Replace Capitalists as Kings of Silicon Valley*, LEGAL TIMES, July 2, 1984, at 1; see generally Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984).

⁹¹See *supra* text accompanying note 70.

This protection seems justified when the only benefit received by way of the accounting, investment or law firms limited participation is a pre-determined fee which rarely covers the large damages sought in Rule 10b-5 actions, and as a result these firms must raise their prices for services beyond the reach of the budding enterprises who need them. Accountants and investment banking firms are essential in opening capital markets to new companies; however, the risk of exposure involved with new technologies is causing collateral participants to either refuse to offer their services or to raise the prices of those services to such an extent that they effectively become unavailable.⁹² For example, plaintiffs who notice a significant stock price decline or earnings decline will file a securities claim naming accounting firms as defendants, regardless of any factual evidence of fault.⁹³ Such suits are a perversion of the securities laws, which are designed to deter wrongdoing and to compensate victims, not to provide insurance against stock price declines or poor investment decisions.⁹⁴ In determining the price of their services, accounting firms will simply add the cost of settling these types of cases. Again, the *Central Bank* Court recognized these "ripple effects" caused by the uncertainty and excessiveness of 10b-5 litigation and stated that "newer and smaller companies may find it difficult to obtain advice from professionals . . . [fearing that] . . . a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others."⁹⁵ The effect of providing disincentives to naming collateral participants when there has been no fraud and proportionately limiting liability to more accurately reflect guilt is to keep valuable markets open to new industries which provide many benefits to the economy through entrepreneurial risk.⁹⁶

C. Effect on Corporate Directors' and Officers' Liability

Related to the problems which joint and several liability pose to capital formation is the impact of possibly disproportionate liability upon management. The introduction of proportionate liability into 10b-5 litigation will have a significant impact on the problems of corporations in attracting experienced outside directors to serve on their boards. In his floor statement on August 12, 1992, Senator Terry Sanford described the problem:

Often, more experienced, successful business managers are unwilling to put their life savings and reputations at risk. For those companies trying to retain and insure the best directors . . . their situations have been exacerbated by . . . costs which merely reflect the risk insurance

⁹²Fischel, *supra* note 10, at 1053.

⁹³*Id.* at 1052.

⁹⁴*Id.* at 1053.

⁹⁵114 S. Ct. at 1454.

⁹⁶*See Cox, supra* note 45.

companies face in guarding directors from suit. In the long run this will hurt American businesses who are finding it more difficult to attract the most qualified people to serve on their boards.⁹⁷

Under current rules of joint and several liability, plaintiffs may individually name outside directors and officers as defendants individually, even when other defendants (especially officers and inside directors) are appreciably more culpable for the alleged misrepresentations and fully able to respond in damages.⁹⁸ Such joinder is extremely beneficial to plaintiffs even in light of the extreme difficulty of attempting to prove personal knowledge of the facts that should have put the defendant directors and officers on notice.⁹⁹ The benefit to plaintiffs is two-fold. First, by suing directors and officers individually, proceeds from directors' and officers' insurance policies become potentially available to plaintiffs.¹⁰⁰ Second, directors and officers can be counted on to be powerful advocates for settlement. These individuals are more risk conscious than many of the entity defendants due to the threat of personal liability, and during the settlement process many individually named directors and officers are still serving on the boards of the entity defendants. Therefore, a personal disposition to settle may influence decisions concerning the entity's position in the litigation.¹⁰¹

For a number of reasons, the likelihood of adjudication on the merits of a case is even more remote when directors and officers are named as 10b-5 defendants. First, directors and officers are extremely risk adverse and pro-settlement because they face liability that is greatly disproportionate to the benefits received from the corporation. In 1989, the average annual salary for outside directors was \$23,000 to \$50,000, while claimed damages for 10b-5 violations soared into the millions.¹⁰² Therefore, a judgment against an outside director could not be satisfied from his compensation from the corporation and

⁹⁷138 CONG. REC. 12,604 (1992).

⁹⁸*See, e.g., In re Fortune Sys. Sec. Litig.*, 680 F. Supp. 1360, 1362-63 (N.D. Cal. 1987). The claimed damages in the suit were \$48.75 million. *Id.* The defendants included the issuer of the stock, which had netted almost \$90 million in cash from its \$100 million initial public offering less than four months before the suit was filed, and a class of 124 underwriters that included Shearson Lehman Bros., Smith, Barney, Harris Upham & Co., and Dean Witter Reynolds. *Id.* Plainly, the entity defendants were able to respond fully in damages. Nevertheless, the complaint also named ten individuals: four officers, one of whom was also a director, and six outside directors. *Id.*

⁹⁹*See Alexander, supra* note 8 (The reason that the knowledge requirement is difficult to prove when dealing with officers and directors is that knowledge of companies' employees can be attributed to the employer but not its directors and officers).

¹⁰⁰*See, e.g., Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (where corporation and directors agreed to pay \$23.5 million in a settlement, \$10 million was paid by director and officer insurance and, fortunately for the directors and officers, the balance was paid by a successful bidder for the corporation).

¹⁰¹*See Alexander, supra* note 8.

¹⁰²*See KORN/FERRY INT'L, BOARD OF DIRECTORS 14TH ANNUAL STUDY 12* (1987).

potentially could consume personal assets derived from other activities and personal wealth. Settlements, in contrast, rarely, if ever, involve significant contributions from individual directors, because settlement agreements normally provide that individual defendants will "cause to be made" certain payments to the settlement fund funded by insurance.¹⁰³

Second, the insurance industry itself also provides a large disincentive to individual defendants to take a case to trial. During the mid-1980's, just as the demand for director and officer insurance was peaking, some insurance companies became wise to the risk of huge liability from directors and officers and the likelihood of settlement. In response to the ruling in *Smith v. Van Gorkom*,¹⁰⁴ they simply stopped offering liability insurance covering Rule 10b-5 claims.¹⁰⁵ Although this ban on director and officer insurance has since been lifted, remnants of the fear of excessive liability have remained in the form of extremely high premiums and the existence of "exclusion" clauses in insurance contracts.¹⁰⁶

The extremely high cost of director and officer insurance is a direct result of the pro-settlement system which has developed.¹⁰⁷ Premiums incorporate the non-merit based claims experience of insurance companies.¹⁰⁸ Insurers realize that they will be forced to fund settlements more often due to individual defendants' risk aversion and uncertainty over the merits. As a result, insurers simply raise rates and place new enterprises in a "Catch-22 situation"—the need for experienced guidance frustrated by the lack of resources to gain directors' and officers' insurance to entice that guidance.¹⁰⁹ In addition, realizing that plaintiffs are equally unsure of the merits of a lawsuit and trial averse, insurance companies will provide insurance at exorbitant costs to defendants and merely negotiate a settlement with plaintiffs for an amount substantially

¹⁰³See Alexander, *supra* note 8.

¹⁰⁴488 A.2d 858 (Del. 1985) (the court abrogated the effectiveness of the presumption of the business judgment rule, which was a common law doctrine of non-liability for corporate judgments of officers and directors); see generally Stuart R. Cohn, *Demise of Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983); Daniel Hertzberg, *Insurers Beginning to Refuse Coverage on Directors, Officers in Takeover Cases*, WALL ST. J., Jan. 20, 1986, at 3.

¹⁰⁵See David B. Hilder, *Risky Business: Liability Insurance is Difficult to Find Now for Directors, Officers*, WALL ST. J., July 10, 1985, at 1.

¹⁰⁶See Karen Slater, *Firms May Find Insuring Boards is Getting Easier*, WALL ST. J., Jan. 13, 1987, at 1 (noting that director and officer insurance, while more available is also more costly; most companies pay \$40,000 to \$50,000 per \$1 million in coverage).

¹⁰⁷*Id.* (insurance rates reflect the frequency of settlement claims of policy holders).

¹⁰⁸See Alexander, *supra* note 8.

¹⁰⁹See generally Michael Brakely & Cindy Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989) (insurance costs will rise as the courts find a broader duty of care for directors, as a result, costs of insurance rose from \$1,358 per million dollars in coverage in 1984 to \$23,386 in 1988).

below the amount of the insurance coverage.¹¹⁰ Therefore, if the current settlement practices remain unchanged, some commentators have predicted that the insurance industry can expect to make a substantial profit at the expense of innocent or only partially-culpable defendants.

The insurance industry has also contributed to the pro-settlement movement in 10b-5 litigation through the introduction of exclusion clauses in insurance contracts.¹¹¹ Under these clauses, if an individual defendant is found guilty of a securities violation, which means such defendant has acted with a culpable state of mind greater than negligence, the policy becomes ineffective. The policies are designed to ensure against mistakes (negligence), not consciously-wrongful acts. These clauses provide an extremely strong incentive for individual defendants to settle, for if there is a settlement, there is no finding of any culpable mental state, and the policy coverage continues.

Many states have addressed the problems similar to the ones just outlined by introducing into their corporate laws a "cap" on the amount of damages that courts may impose on directors in cases other than those involving intentional or willful misconduct.¹¹² Commentators have attributed the success of this "cap" approach to the fact that it subjects directors and officers to less risk of catastrophic financial loss while retaining some exposure to liability.

The latter acts as an incentive for directors to use care, retaining the protection for shareholders by deterring culpable conduct.¹¹³ This approach also has been praised because it provides stability to the volatile directors' and officers' insurance market by eliminating fears of enormous damage awards and reducing costs.¹¹⁴

Similarly, the Bill seeks to limit liability of directors, officers, and other actors to be proportional with each actor's degree of culpability. Although proportional liability does not remove the difficulty of determining whether a defendant will be held substantively liable, it does remove the incentive to disregard the merits of the case in settlement negotiations.¹¹⁵ If an outside director knows that he may only be held liable for an amount of damages proportional to the level of his culpability as determined by a jury and that plaintiffs will have a difficult time establishing that there was actual knowledge of the facts giving rise to the lawsuit, an individual defendant's risk aversion may be reduced, and he may be more willing to go to trial or to settle for an

¹¹⁰See generally Rosenberg & Shavell, *supra* note 73.

¹¹¹See Slater, *supra* note 106, at 1; Thomas J. Neff, *Liability Panic in the Board Room*, WALL ST. J., Nov. 10, 1986, at 22.

¹¹²See, e.g., CAL. CORP. CODE § 204(A)(10) (West 1990); N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1991); VA. CODE ANN. § 13.1690 (Michie 1989); see generally R. Link Newcomb, *The Limitation of Director's Liability: A Proposal for Legislative Reform*, 66 TEX. L. REV. 411 (1991); Alexander, *supra* note 8, at 118 n.373.

¹¹³See Newcomb, *supra* note 112.

¹¹⁴*Id.*

¹¹⁵See *supra* text accompanying note 86.

appropriately lower amount. In addition, by imposing proportional liability, the imbalance between economic gain from working on a board and the degree of possible exposure is reduced, encouraging more outsiders to agree to sit on boards.

Furthermore, there would be reduced justification for continuing to include non-merit based settlement risks in insurance premiums, thus reducing rates. By reducing rates, insurance becomes more readily available, and entrepreneurial enterprises will then have the ability to offer insurance protection and attract experienced board members.

D. Effect on Initial Decision to Bring Frivolous 10b-5 Actions

By relieving the pressure to settle unmeritorious suits caused by joint and several liability, proportionate liability, in theory, will prevent unmeritorious lawsuits from being brought. The premise for this argument is that plaintiffs' attorneys who are less likely to recover their costs and fees due to the prospects of trial will be forced to investigate the merits of their cases in order to determine whether the cases will bring favorable trial outcomes. If plaintiffs recognize that the expected value of going to trial is negative, either because the chances of winning are small (the case is frivolous) or the expected value of the judgment is small relative to the expected value of litigation costs, the plaintiff should not bring the case.¹¹⁶ However, under the present system this negative expected value of litigation does not deter plaintiffs who are hoping to merely extract a settlement and who do not intend to go to trial.¹¹⁷

The most important incentives for plaintiffs and their attorneys in bringing a cause of action are compensation and fees. The fee award system in securities class actions provides plaintiffs' attorneys strong incentives to resolve cases by settlement rather than trial. If the attorneys obtain a recovery for the class, either by judgment or by settlement, they receive their fees and expenses out of the recovery.¹¹⁸ If plaintiffs' attorneys lose the class claims at trial, the time spent on the case is not compensated, and the out-of-pocket expenses will have to be absorbed.¹¹⁹ Considering the high costs of securities actions,¹²⁰ an assured recovery from settlement seems preferable. The added risk, created by the introduction of proportionate liability, of actually having to take a case to trial (because the defendant more likely will refuse to settle) and the risk of having

¹¹⁶See generally Bebhuk, *supra* note 73.

¹¹⁷*Id.*

¹¹⁸See Alexander, *supra* note 8.

¹¹⁹*Id.*

¹²⁰ See, e.g., Carole Kahn, *The Big-Stakes Battleground of Shareholder Suits*, N.Y. TIMES, Jan. 10, 1988, at 13, col. 1; Paul D. Freeman, *The World of Shareholder Litigation According to Bill Lerach*, CAL. LAW, Apr. 1989, at 83 (quoting William S. Lerach, a partner in the prominent securities plaintiff's firm of Milberg, Weiss, "[W]e've had some catastrophic failures costing hundreds of thousands in costs and millions in uncollected attorney's fees.").

to absorb lost income and costs in the event of an adverse verdict should curtail the bringing of lawsuits only for their settlement value.¹²¹

E. Does the Doctrine of Contribution Provide an Answer?

The equitable doctrine of contribution allows defendants to require other tortfeasors, even those not named by the plaintiff, to bear their fair portion of the plaintiff's damages.¹²² Historically, contribution was not available in the intentional tort context where 10b-5 has its origins.¹²³ In addition, there is no express provision for contribution included in section 10(b), but the United States Supreme Court has held that a right to contribution exists in 10b-5.¹²⁴ Prior to *Musick*, the rationale of courts finding such a right had been that contribution under a 10b-5 action was consistent with the specific liability provisions of the 1934 Act which expressly provides for a right of contribution in areas other than section 10(b).¹²⁵ One court has said that this trend is motivated primarily by the policy objective of fairness to defendants.¹²⁶ In calculating the amount of damages to be paid by each defendant, whether named or impleaded, the courts originally used a *pro rata* methodology, which is to simply divide the total amount of damages awarded by the number of defendants found liable.¹²⁷ For example, in *Globus, Inc. v. Law Research*

¹²¹ See Alexander, *supra* note 8, at 527 (an increased risk of losing fees may discourage representation of unwarranted claims).

¹²² See generally W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS § 50 (5th ed. 1984); see also *Granada Invs., Inc. vs. DWG Corp.*, 962 F.2d 1203, 1205 (6th Cir. 1992); *Nelson v. Bennett*, 662 F. Supp. 1324, 1328 (E.D. Cal. 1987).

¹²³ See RESTATEMENT (SECOND) OF TORTS § 886A(3) (1977) (The intentional tort analogy is appropriate in 10b-5 actions as evidenced by the Supreme Court's requirement that a defendant act intentionally in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)).

¹²⁴ *Musick, Peeler & Garrett v. Employees Ins. of Wausau*, 113 S. Ct. 2085 (1993).

¹²⁵ See, e.g., *Smith v. Mulvaney*, 827 F.2d 558, 560 (9th Cir. 1987); *Huddleston v. Herman & Maclean*, 640 F.2d 534, 557 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983); *Tucker v. Arthur Anderson & Co.*, 646 F.2d 721, 727 (2d Cir. 1981); *Heizer Corp. v. Ross*, 601 F.2d 330, 335 (7th Cir. 1979); *deHaas v. Empire Petroleum Co.*, 286 F. Supp. 809, 815 (D. Col. 1968), *modified on other grounds*, 435 F.2d 1223 (10th Cir. 1970); see also Annotation, *Right to Contribution Among Defendants in Action Under 10(b) of Securities Exchange Act of 1934* 915 USCA 78j(b) or SEC Rule 10(b)-5, 62 A.L.R. FED. 802-19 (1983) (analyzing cases finding contribution in 10b-5 actions).

¹²⁶ See *Nelson*, 662 F. Supp. at 1328:

[This] trend . . . has been motivated primarily by two policy objectives: fairness to defendants and deterrence. First, and probably most importantly contribution achieves a more fair and equal distribution of justice by spreading plaintiffs' losses proportionately among all wrongdoers. . . . Otherwise, under the traditional common law rule, plaintiffs could unilaterally force one of many wrongdoers to bear the entire loss, even though others may be equally or more to blame.

¹²⁷ See generally Patricia B. Hogan, *All Things Being Unequal: Use of the Doctrine of Relative Culpability in Apportioning Contribution*, 57 U. CIN. L. REV. 769 (1988).

Services,¹²⁸ the court held that the appropriate method of contribution should be on a *pro rata* basis in a 10b-5 action. In *Globus*, three defendants had prepared a misleading offering circular and were found to be jointly and severally liable. One defendant, the underwriter of the stock, paid the full amount of the judgment. In a second court proceeding, the underwriter persuaded the court that it was entitled to contribution from both the issuing company and the issuer's president. The court proceeded to divide the judgment into three equal portions, one for each of the three culpable parties.

Under the *pro rata* measure of contribution, defendants have no increased incentive to take cases to trial because the extent of liability has no relation to the degree of their culpability; instead, a defendant's liability is determined simply by dividing by the number of guilty parties. This retains settlement as the preferable method of dispute resolution. Accordingly, some courts have held that a contribution methodology based on the *pro rata* system is not mandated by the Securities Acts of 1933 and 1934, and a balance of the relative fault of the defendants is appropriate in some situations.¹²⁹ In *Pepsi Co., Inc. v. Continental Casualty Co.*,¹³⁰ the court recognized the wisdom of the relative fault methodology and held that a defendant insurance company, which paid the full amount of a director's and officer's liability policy, was entitled to contribution from two other defendants "[b]ased upon the notion of relative of fault."¹³¹

In effect, the circumstances sought by the proposed legislation, from a defendant's perspective, could be largely achieved simply by impleading other culpable defendants and bringing a cross-claim based upon the theory of contribution. Under a relative fault system, marginally culpable defendants would reduce their degree of exposure to more accurately represent their proportionate share of liability. However, as stated, normally the most culpable defendants do not have assets to contribute.¹³² As a result, even if contribution was available on a relative fault basis, marginally culpable defendants still could pay a disproportionate share of the damages.

V. CONCLUSION

As demonstrated, the onus of joint and several liability consists of the risk of being held disproportionately liable in comparison with the degree of one's culpability. This imbalance creates substantial incentives for defendants to settle lawsuits regardless of the merits of the case and substantial incentives for plaintiffs to name innocent or only marginally culpable defendants in order to

¹²⁸318 F. Supp. 955, 957-58 (S.D.N.Y. 1970), *aff'd per curiam*, 442 F.2d 1346 (2d Cir.), *cert. denied*, 404 U.S. 941 (1971).

¹²⁹See Hogan, *supra* note 127.

¹³⁰640 F. Supp. 656 (S.D.N.Y. 1987).

¹³¹*Id.* at 669.

¹³²See *supra* text accompanying note 87.

extract settlement amounts disproportionate to the degree of culpability. Also, by holding marginally culpable defendants liable for the full amount of damage awards causes a deterioration in the availability of capital markets to those unable to pay the higher prices for services. The legislation, as a remedy, seeks to diminish the disparity between an individual's culpability and his share of the damages by introducing into 10b-5 litigation a system of proportionate liability. In many circumstances this will mean a reduced recovery for innocent investors.

The proposed legislation seems to strike the proper balance. The interests in protecting innocent defendants from frivolous lawsuits and avoiding disproportionate liability for marginally culpable defendants are balanced with the interests in maintaining the original purpose of the securities acts, the protection of investors, by retaining joint and several liability for knowing violations of Rule 10b-5. The proposed legislation does not discourage plaintiffs or their attorneys from bringing meritorious claims to court. Defendants who violate securities laws should not reap economic gain from wrongful acts and then go unpunished; however, innocent or marginally culpable deep pocket defendants should not be forced to subsidize the legal witch hunt that has developed under the guise of joint and several liability. The Supreme Court in *Central Bank* has taken the first step by removing aiding and abetting liability from 10b-5 litigation. The proposed legislation represents the next step necessary to reform this area of law no longer fairly or wisely serving its original purpose.

ALAN S. RITCHIE



IN MEMORIAM

THE HONORABLE FRANK J. BATTISTI
(1922 - 1994)